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SUBJECT: SHANGHAI ENERGY EXPERTS - COAL IS KING

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¶11. (SBU) Summary. With summer peak demand for power approaching in East China, another round of possible thermal coal shortages is causing great concern. Industry experts said the main bottleneck in China's thermal coal supply is transportation, although coal exports (encouraged by a gap between world and domestic prices) and closures of small mines are also exacerbating factors. Power generation companies are trying to improve efficiency and diversify their energy mix, but many experts believe that East China will remain heavily dependent on coal well into the future. Local governments are also looking for ways to improve energy efficiency and promote environmental protection to improve the power situation. End Summary.

¶12. (SBU) Econoff recently met with Shanghai energy analysts and municipal government officials to discuss energy issues in East China. (Non-power related energy issues reported septel.) Meeting participants included investment research firm CLSA's Deputy Head of China Research Utility and Machinery Sectors Manop Sangiambut, Shanghai Economic Commission Deputy Director of Economic Operation Department Wu Jin Cheng, a McKinsey partner specializing in energy consultancy, and a Shanghai based energy analyst for BHP Billiton.

Transportation Bottlenecks Cause Coal Shortages

¶13. (SBU) Both Sangiambut of CSLA and the McKinsey consultant separately agreed transportation bottlenecks are the primary cause of coal shortages. They noted heavy floods in Southern China have aggravated the problem, but transportation remains the biggest concern. According to Sangiambut, the central government is adding 10-15 percent extra railway capacity every year, primarily for coal transportation. Deputy Director Wu observed a major expansion of the Daqing Line is underway, noting it will help relieve the bottleneck for coal movement between Datong in Shanxi province, a key area for coal production in China, and Qinhuangdao in Hebei, a port city that ships coal to the coastal areas where large amount of electric power is needed to fuel economic growth. According to Wu, Shanghai receives most of its coal by sea.

Coal Exports on the Rise

14. (SBU) Increasing coal exports are also lowering domestic coal supplies. According to a July 10 article in Chinese Business News, coal exports in June increased 83.5 percent year on year to reach 6.99 million tons, the highest level since March 2005. Total coal exports of 25.49 million tons from January to June this year mark an increase of 10.2 percent compared to the same period last year. The main reason for the increase is a relatively high world price, the article explains.

Even though the domestic coal price has also soared from below RMB 600 (USD 88) per ton in April to over RMB 1,000 (USD 147) in early July, domestic prices are still below world coal prices at about 200 USD. Interlocutors speculated that the central government will adopt policies to discourage coal exports in the second half of 2008.

Small Mine Closures

15. (SBU) The closure of small mines is another factor contributing to tight coal supplies. For environmental and safety reasons, the central government has been closing small privately owned mines. Wu remarked all small mines under 300,000 tons of annual production are still closed, while those above 300,000 tons are undergoing safety changes before resuming production to relieve coal shortages. Although the general belief is that coal mining capacity from small mines is one third of total capacity, the BHP Billiton analyst believes that number could be as high as 50 percent.

Price Cap Increases May Not Significantly Help Generators

16. (SBU) The National Development and Reform Commission announced on June 19 the initiation of an intervention mechanism

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to temporarily control coal prices until the end of 2008. During this period, coal prices for power generation are not to exceed the June 19 spot price. While this announcement gives power generation companies hope for temporary price stability, the McKinsey consultant does not believe that the price cap will significantly help generators. He noted that the policy only applies to state-owned coal mines, while many independent mines are not subject to the price cap. Second, as transportation costs are not included, the final price power companies pay may vary greatly. He noted, for example, the price for the same thermal coal can more than double from Inner Mongolia to Shanghai.

China Will Diversify, But Coal Will Remain Central

17. (SBU) CLSA's Sangiambut observed power generation companies, facing record high coal prices and growing domestic demand for electricity, are trying to improve efficiency and diversify their energy mix. He also noted the government is working on a more extensive energy conservation campaign. For instance, they are trying to invest in more efficient plants, as well as upgrade existing 600 MW plants to 1,000 MW. He observed that on average, 1,000 MW plants are about 20 percent more efficient than 600 MW plants (i.e. requires 20 percent less input per unit energy).

18. (SBU) Sangiambut speculated that over the next 10 years, coal will remain the main energy source for China, though its current 70 percent share of China's energy portfolio will likely decline to 60 percent by 2020. In the interim, present investment in coal will cause its share to peak at 75-85 percent before subsequently declining. The McKinsey consultant expected an even larger decline to 50 percent by 2020. He similarly expected coal's share to peak in the near term.

19. (SBU) Regarding other energy sources, Sangiambut estimated hydro's share of China's energy portfolio will drop from 20 percent to 15 percent as the most easily tappable hydro energy

is already being harnessed for electrical generation. Nuclear, he believes, will increase from 2 percent to 4 percent, while liquefied natural gas (LNG) will increase to 10-15 percent over the next 10 years. Both he and the McKinsey consultant suggested China's LNG potential is limited due to already tight global supplies. Other renewables such as wind, solar and biofuel will also increase, but will remain only a small portion of China's total energy mix.

Energy Conservation Efforts

¶10. (SBU) Wu from the Shanghai Economic commission noted that coal-fired power plants are still Shanghai's dominant source of energy. However, with the recent national focus on environmental protection and energy efficiency, Shanghai has taken several steps to limit pollution and promote conservation.

For instance, Shanghai's natural gas fired plant is increasingly being used for peak demand. Natural gas produces about half the carbon emissions of a coal fired plant, without emitting nearly as much sulfur or other polluting chemicals Wu observed. Wu also noted energy intensive and high polluting enterprises are being requested to make changes or suffer a higher power tariff. Wu mentioned the local government is also giving out subsidies for energy-saving bulbs.

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